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Washington, D. C.

SUMMARY OF CASES

RELATING TO

FARMERS' COOPERATIVE ASSOCIATIONS

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Prepared under the direction of

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COOPERATIVE RESEARCH AND SERVICE DIVISION

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FARM CREDIT ADMINISTRATION

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Cases involving and affecting the legal status and operations of cooperative associations are being decided by the courts from time to time. In order to assist attorneys for cooperative associations, and others concerned with such associations, in obtaining current information regarding legal questions affecting their organization and operations, summaries such as this are issued quarterly. Requests to be placed on the mailing list to receive issues of this publication should be made to T. G. Stitts, Chief, Cooperative Research and Service Division, Washington, D. C.

SUMMARY OF CASES RELATING TO FARMERS' COOPERATIVE ASSOCIATIONS

CONTENTS

FIDUCIARY RELATIONSHIP BETWEEN ASSOCIATION AND ITS MEMBERS - RIGHT OF WITHDRAWING MEMBERS TO THEIR PRO RATA SHARES OF UNDISTRIBUTED CROP PROCEEDS

Certain members of a local walnut growers association brought an action for an injunction to restrain the association from paying to withdrawing members funds received by the local association from the central association of which it was a member out of the operating reserve fund of the latter association, and to have the court declare that all funds received by the local association from the central asscciation out of its "Present Operative Reserve Fund" was the money and property of the local association and that all persons who had ceased to be members of the local association had no right, title or interest in or to any of the said funds.

The association and certain members who had withdrawn from the association and intervened in the proceedings demurred to the complaint. The demurrers were sustained and the action was dismissed by the lower court. On appeal to the District Court of Appeals, Fourth District of California, the judgment of the lower court was affirmed.

Under its contract with its members, the local association agreed to resell their walnuts and to pay over the net amount received to the growers. The proceeds of resale were to be distributed to the growers as rapidly as the local received them from the central association. The bylaws of the local association provided that it should operate on a nonprofit basis; that all the net sales proceeds be paid over to members; and that in case any member ceased to be a grower of walnuts through it, his membership should cease and be canceled and that such member should not be entitled "to any appraisement of, or further interest in, the property of the association, other than the interest given him under the bylaws relating to 'Revolving Fund,' and each member expressly waives his right to said property, other than his interest in the 'Revolving Fund,' upon the cancelation of his membership."

In the "Central-Local Agreement" under which the walnuts of the members of the local associations were delivered to and sold by the central association, the central agreed to buy from each local and each local agreed to sell to the central all of the walnuts acquired by the local; and the central agreed to resell the walnuts and pay over the net proceeds after payment in full to the local. It was further agreed that the proceeds of resales of walnuts made by the central should be distributed to locals from time to time.

From 1921 to 1935, the central association followed the practice of appraising and estimating the probable gross proceeds which it would receive during each crop year for the walnuts delivered to it, and from that estimate the central association deducted its

estimated expenses and arrived at an estimate of the probable walnut sales proceeds for the year in question. Prior to the sale of the walnuts, the central association advanced to the local associations their pro rata shares of the estimated net proceeds for that particular year. The local association distributed in turn to its members their pro rata shares of the advance payment according to the amount of their respective contributions of walnuts.

Surpluses or excesses received by the central association on the sale of the walnuts were from year to year retained by it and placed in a separate special fund known as the "Present Operative Reserve Fund." This fund, after deducting losses sustained in the years 1926 and 1933, amounted to the sum of $697,479.70. The interest of the local association in that fund amounted to $42,717.08. At the time the complaint was filed, the central association, in pursuance of a special agreement entered into by it with the local association, had already paid it three yearly installments of $8,543.41 on its interest in that fund.

On February 15, 1939, the board of directors of the local association adopted a resolution directing that all monies received by it from the central association out of the "Present Operative Reserve Fund" be immediately paid and distributed by the association, pro rata, to the persons who contributed to said fund from time to time by marketing their walnuts in that proportion in which they contributed, regardless of whether such persons were then still members of the local association.

The appellants contended that the marketing contracts were contracts of absolute purchase and sale, and consequently that no fiduciary relationship existed between the association and its members. Regarding this point, the court stated:

> "It is respondents' contention, with which we agree, that at all times the relationship between the grower member and the local association, and between the local association and the central association, was that of principal and agent, or beneficiary and trustee; that a fiduciary relationship existed which required at all times that these associations account to the grower member for all proceeds received from the sale of walnuts, and required the grower member to bear his proportionate share of all losses sustained in the marketing and sale of walnut products. In support of this contention Texas Certified Cottonseed Breeders' Ass'n v. Aldridge, 122 Tex. 464, 61 S. W. 2d 79, and Rhodes v. Little Falls Dairy Co., Inc., 230 App. Div. 571, 245 N.Y.S. 432, are cited. Both of these cases involve actions between a member of a nonprofit cooperative marketing association and said association for an accounting, and for the determination of rights involving proceeds received from sales of marketed products. In each of

these two cases marketing contracts had been entered into between the purchaser and association, which contracts provided for the immediate passage of title and were otherwise couched in terms of outright purchase and sale. In each of the cases cited the court held that the provisions for passage of title, and the terms of purchase and sale, were merely for convenience in marketing operations and that the real relationship between the parties was one of trust, or of a fiduciary character. Appellants cite several cases which reach a contrary conclusion and hold that the contracts under consideration were agreements for outright sale and purchase and that no fiduciary relationship existed. McCauley v. Arkansas Rice Growers' Co-op. Ass'n, 171 Ark. 1155, 287 S. W. 419; Winter Garden Citrus Growers' Ass'n v. Willits, 113 Fla. 131, 151 So. 509; Fletcher Cyclopedia Corporations, vol. 16, sec. 8286, p. 1205; Callaway v. Farmers' Union Co-op. Ass'n, etc., 119 Neb. 1, 226 N.W. 802, and Texas Farm Bureau Cotton Ass'n v. Lennox, 117 Tex. 94, 297 S. W. 743.

"Respondents claim to have made an exhaustive examination of the California law and are unable to find any cases directly deciding this point. Our attention, however, has been called to the case of Mountain View Walnut Growers' Ass'n v. California Walnut Growers' Ass'n, 19 Cal. App. 2d 227, 65 P. 2d 80, which was an action between one of the members of a local association and the California Walnut Growers' Association, and involved a controversy regarding a similar fund of money to that which is here in controversy, viz., the 'Present Operative Reserve Fund.' One of the same forms of marketing contracts, i.e., a 'Central-Local Agreement,' such as the one here involved, was also there under consideration. The local association in that action was seeking the return of its pro rata share of the 'Present Operative Reserve Fund' and at the time that action was instituted . . . no agreement had been entered into between the central association and its local association members for the distribution of that fund, and the central association was still holding that fund in its possession. Although the court there held that the local association's action was premature, it did hold that the 'Present Operative Reserve Fund' was not the property of the central association but was, as agreed upon by the parties, a trust fund, and that the local association was entitled to its pro rata share of the money when the funds should be distributed. It becomes apparent then that the decision does constitute and hold that the 'Central-Local Agreement,' which is the same in substance as the one here involved, was not a contract of outright purchase and sale, because if it has been so held, then it would have been incumbent upon the court to have said that when from year to year the central association advanced moneys to the local association on account of crop proceeds, under the terminology of

the agreement, the local association was paid in full. We are therefore convinced that if the money here in controversy was a trust fund while it was in the hands of the central association, then it clearly is a trust fund while in the hands of the local association and that each member who contributed to that fund is entitled to receive his pro rata share thereof. It therefore appears to us that under the rule here adopted, the ultimate and final benefits should be distributed to those persons who contributed their walnuts in proportion to their contribution. Not only is this rule a fair and equitable one and in harmony with the nonprofit cooperative character of these associations, but it is a rule which was contemplated by the parties to this action as shown by the following excerpts from the bylaws of the respondent local association and from the marketing contracts here involved. Article X(a) provides that the local association's business shall not be carried on for profit, but that the profits realized by it in the marketing of its members' walnuts shall be distributed to the persons delivering their walnuts to the association. Section VI(b) of the growers' contract contains this provision: 'If Local, . . . shall advance . . . to growers . . . more than the amount to which said growers are . . . entitled . . . grower . . . agrees . . . to . . . repay . . . to Local so that said grower shall receive neither more nor less than the amount to which he is entitled.'

"The Central-Local Agreement contains an identical provision with reference to overpayment to the local association. This clearly indicates that it was the intention of the parties that each contributing member of respondent local association was ultimately to receive the entire net proceeds from the sale of his walnuts, and that no one payment, or advancement, was to be considered as final, or payment in full, if, in fact, later developments should disclose that the net proceeds from the sales of his crops were greater or less than the amount so advanced to him." (Underscoring added.)

In holding that the interest of the local association in the "Present Operative Reserve Fund" of the central association was not property of the local association, but rather additional sales proceeds due to the members of the local, the court stated:

"Section III(c) of the growers' contract provides for the termination of, or a member's withdrawal from said marketing contract and then provides that nothing in said paragraph shall impair or take away any of the rights of either or any of the parties to said agreement against the other parties existing at the time of such termination or withdrawal. It therefore appears that there is no authority under the marketing contract or bylaws of respondent local association which would

permit that association to now, for the first time, elect to retain this money, which represents crop proceeds from past years, as a reserve or other fund for future operations, especially where a portion of that money constitutes the balance of net proceeds received from walnuts contributed from persons who no longer are members of the local association and who could receive no benefit from such a reserve or other fund. We therefore conclude that the rule of forfeiture established by the bylaws and by the general laws that a member who voluntarily withdraws from a nonprofit cooperative marketing association loses his right to an interest in association property, other than his interest in the association's revolving fund, applies only to the property or assets of the association, and has no application to unpaid and undistributed crop proceeds money received from the sale of walnuts contributed by the withdrawing member to that association for marketing, prior to the date of his withdrawal, and the balance of crop proceeds money is the property of the person who contributes his crop. Hood River Orchard Co. v. Stone, 97 Or. 158, 191 P. 662; Ozona Citrus Growers' Ass'n v. McLean, 122 Fla. 188, 165 So. 625; Buford v. Florin Fruit Growers' Ass'n, 210 Cal. 84, 291 P. 170 (citing Hood River Orchard Co. v. Stone, supra); Loomis Fruit Growers' Ass'n v. California Fruit Exchange, 128 Cal. App. 265, 16 P. 2d 1040. In the last-cited case the court said, 128 Cal. App. at page 280, 16 P. 2d at page 1046: 'The Buford case need not be considered further than simply supporting what we have said, that the withholdings made by the exchange were of moneys belonging to the association and to the growers marketing fruit through the exchange.'

"Both under the facts alleged in the complaint and under the law applicable thereto, the moneys in controversy constitute the balance of net proceeds received from the sale of walnuts contributed to the local association for marketing during the years from 1921 to 1935, inclusive, and, as such, are the property of, and belong to, those persons who contributed their walnuts for marketing during that period. It is therefore apparent that the complaint does not state facts sufficient to constitute a cause of action and that the rulings upon the demurrers were proper." (Underscoring added.)

Bogardus v. Santa Ana Walnut Growers Association, _____ Cal. App. _____, 108 P. 2d 52.

LANDLORD HELD LIABLE FOR ADVANCES MADE TO TENANT

In a recent action in California, a landlord was held liable for advances made to his tenant by reason of the fact that he had executed jointly with the tenant a marketing agreement, which the association had refused to accept without the landlord's signature. An appeal was taken to the District Court of Appeals of the Third District of California, which, in affirming the judgment of the lower court, stated as follows:

> "Plaintiff was, during all the times herein mentioned, the owner of a ranch consisting of some 30 acres of bearing apple trees. On February 10, 1937, he leased the property to one Edward King, upon a share rental basis. Shortly thereafter, King entered into negotiations with respondent association for the purpose of securing an agency to handle his coming crop. He was told by the latter that they would not enter into a marketing contract with him unless appellant executed and signed it. This was explained to appellant and he thereupon executed the contract as one of the parties of the second part, King being the other. The agreement was in the following language:
>
> "'This agreement, made this 4th day of March, 1937, by and between Gravenstein Apple Growers Cooperative Association of Sonoma County, a corporation, hereinafter called first party, and J. G. McDonald and Edward E. King, hereinafter called second party,
>
> "'Witnesseth:
>
> "'1. That said second party hereby agrees to sell exclusively to or through the first party, or any facilities to be created by first party, all of the apples raised and produced during the period of 15 years from and after the date hereon on that certain property situate in the County of Sonoma, State of California, more particularly Described as follows:
>
> "'30 acres Gravenstein apples located 1 1/2 west of Sebastopol - estimated - lugs 8000 - 10,000 including 1 acre of Late Apples - J. G. McDonald to receive 1/3 and Ed King 2/3 - All spray materials except fertilizer 1/2 to come out of Ed King's part.
>
> . . .
>
> "'4. It is agreed that said first party may sell or resell the apples delivered to it by second party with or without taking title thereto, and pay over to second party the resale price

after deducting all necessary selling, overhead and other costs, expenses, and deductions provided for in the bylaws of said first party. . . .

"'5. It is further agreed that this contract shall constitute a lien upon all of said apples for the repayment to first party of any and all advances made to said second party, or which shall be made to said second party, and that any and all of such advances may be withheld by first party from the proceeds of such apples . . .

"'7. Said first party agrees to pay to second party the net proceeds of all sales of said apples, after making the deductions authorized by the bylaws of said first party. . . .'

"When the crop was sold it brought $561.37. When appellant demanded his share of the proceeds, he was notified that advances had been made to King totaling $1,147.61 - $432.61 in goods, wares, and merchandise, and $715 in cash; that since the proceeds from the crop were not large enough to cover the advances, his share was being withheld as an offset against them, and that he would be held personally liable for the remaining deficiency of $586.24.

"It is the contention of appellant that the finding to the effect that both appellant and King, under said contract, received advances of cash from respondent association, and that certain articles were delivered to them by said respondent, is not supported by the evidence. He states that the record shows, without dispute, that such advances and merchandise were all received by King alone. We agree that appellant is correct, but as will hereafter appear, such a finding is not material in establishing the liability of appellant under said agreement and upholding the judgment.

"It appears that respondent association would not sign the marketing agreement unless it was signed by appellant. This was clearly understood by appellant when he affixed his signature. The gist of the chief contention made by appellant is that he is not primarily liable upon the contract in the same manner and to the same extent as his cosigner King, for the reason that he received none of the advances or supplies which are the basis of this action. In other words, appellant says he should not be forced to pay for something he never received. Assuming that there is merit in such contention, we are of the opinion that appellant, under the evidence, could be held primarily liable as a guarantor.

"'A surety or guarantor is one who promises to answer for the debt, default, or miscarriage of another, or hypothecates property as security therefor.' (Civ. Code, sec. 2787.)

"The trial court could have impliedly found that appellant signed the contract, not as a principal, but as a guarantor, in order that his tenant could procure the capital and supplies for the properly carrying out of the lease. 'Where a guaranty is entered into at the same time as the original obligation, or with the acceptance of the latter by the guarantee, and forms with that obligation a part of the consideration to him, no other consideration need exist.' (Civ. Code, sec. 2792.) The guaranty here arises, out of the original contract, and hence is supported by a legal consideration. Furthermore, 'the delivery of the goods, upon the faith of a guaranty that they shall be paid for, constitutes a sufficient consideration for the guaranty.' 12 R.C.L., § 29, p. 1078. The promise to pay is absolute and unconditional; therefore, the liability of the guarantor is fixed when the principal obligation matures, and is not predicated upon the exhaustion by the creditor of his remedy against the original debtor. 13 Cal. Jur., § 22, p. 110. Applying the foregoing legal principles to the facts as established here, there was ample evidence to support an implied finding that appellant was primarily liable for the indebtedness, notwithstanding that he did not personally receive any of the money or goods which are the basis of the account.

"It is contended by appellant that the contract is, in effect, a mortgage as to him, because there is no express promise to pay for the advances and supplies. This court has held that a contract containing almost identical terms, 'necessarily implies that the grower will reimburse the association for all such advances.' California B. G. Ass'n v. Williams, 82 Cal. App. 434, 255 P. 751, 754. Here there was an implied promise upon the part of the tenant to reimburse respondent-association, and appellant guaranteed that such reimbursement would be made. This, accepting the theory of appellant, would take the agreement out of the category of a chattel mortgage. We might add that we can find no substantial evidence in the record to support a finding that the agreement was in fact a chattel mortgage, either between appellant and King, or with reference to third parties.

"Next, it is contended by appellant that the foregoing italicized portion of the agreement limits the liability of appellant to one-half of the fertilizer expense. It was immaterial to respondent-association how King and appellant

apportioned, between themselves, the indebtedness to it. If King were personally responsbile for the entire amount, appellant would still be liable as a guarantor for the repayment of such amount.

"Finally, appellant refers to the provision of the contract which gives the association a lien upon all the apples, and contends that no action can be brought until the security is exhausted, which, he says, would be fifteen years from the date of the agreement. This theory is based upon conclusion that the evidence shows, without dispute, that the whole transaction was intended to be a mortgage. The trial court impliedly found otherwise, upon sufficient evidence, as we have pointed out above.

"In view of the foregoing, we deem it unnecessary to discuss the view of respondents that appellant can be held liable under the rule that: 'A party is presumed to have assented to all the terms of a written contract when he signs it.' Eldridge v. Mowry, 24 Cal. App. 183, 140 P. 978, 981.

"Appellant has received the benefit of a considerable amount of the supplies furnished for the proper care of his property. He knew exactly what he was signing, and it can be reasonably inferred that respondents entered into the contract relying upon the fact that appellant had signed it in the capacity of guarantor. Both justice and equity require that appellant should reimburse respondent-association."

McDonald v. Gravenstein Apple Growers Co-Operative Ass'n of Sonoma County, _____ Cal. App._____, 108 P. 2d 936.

A COOPERATIVE ASSOCIATION HELD NOT LIABLE FOR PERSONAL INJURIES RESULTING FROM UNSAFE PREMISES OF A LOCAL ASSOCIATION TO WHICH IT HAD ISSUED A CHARTER

Charles M. Eakins brought an action against the Farmers' Educational and Co-Operative Union of America, a Texas corporation, for personal injuries which he sustained upon getting out of his automobile and stepping into a hole in the driveway of the gasoline station operated by the Oklahoma State Union, a local cooperative which was chartered by the Farmers' Educational and Co-Operative Union of America.

From a judgment rendered the plaintiff in the trial court, an appeal was taken to the Supreme Court of Oklahoma. In reversing this judgment, the Supreme Court said, in part:

"The evidence is to the effect that the gasoline service station where plaintiff's injury occurred was operated by the Oklahoma State Union, which it is admitted was chartered by the defendant corporation. Further evidence is to the effect that the Oklahoma State Union is managed and controlled by officers other than the officers of the defendant corporation; that the defendant corporation has or claims no interest in any of the property belonging to the Oklahoma State Union; that it does not participate in any of the business activities of the State Union; does not share in any of the profits or losses of the State Union in its business enterprises; that when and if the State Union engages in any business enterprise it does so under the sole authority of its own constitution and bylaws, and under the exclusive control and management of its own officers, and that the defendant corporation has no control, authority or supervision over the officers or employees of the State Union, particularly in the matter of the conduct of any business enterprise in which the State Union may have been engaged. Such evidence is not denied.

"From the charter and constitution of the defendant corporation it is doubtful if authority is given for it to engage in any manner in the retail sale of gasoline, and it seems therefore that it is unlikely that it would attempt to confer that authority upon any of its local unions to which it might issue a charter. There is nothing in evidence to show that the defendant corporation in any manner attempted so to do in the present case. There is no evidence herein to show that the defendant corporation controlled or attempted to control any of the persons or activities here shown to have been the cause of the injury, or that it had any interest in the filling station property or shared in any of the profits. In doing the things which it is said caused the injury, the persons so acting were not serving the defendant corporation in any capacity.

"While the evidence discloses plaintiff's personal injury, there is a total failure of competent evidence to show that this defendant operated the filling station or was interested in its operation, or was in any way concerned in the maintenance of the driveway, or was in any way responsible for the defective condition thereof. There is therefore no competent evidence sustaining liability of this defendant for plaintiff's injury. There is no competent evidence to show that the State Union operated the gasoline station as an agent of this defendant."

Farmers' Educational and Co-Operative Union of America v. Eakins, _____Okl._____, 108 P. 2d 182.

RIGHT OF A NONEXEMPT COOPERATIVE TO DEDUCT CREDITS TO A "PATRONS' EQUITY RESERVE" IN COMPUTING TAXABLE NET INCOME

A cooperative wholesale association having as members 180 local cooperative associations brought an action before the United States Board of Tax Appeals to recover alleged overpayments in its income tax for the years 1936 and 1937. It was the contention of the association that the Commissioner of Internal Revenue should have permitted the deduction from its gross income for the taxable years of amounts credited by the association to its members, and held in its patrons' equity reserve.

It appears that in each of the years in question, the board of directors of the association, within the fiscal year, had adopted a resolution under which part of the earnings were to be distributed in cash and part of the earnings placed in the patrons' equity reserve. In each instance, in the succeeding year, a suitable allocation was made of the earnings placed in reserve during the previous year, and the action of the board of directors with regard to the disposition of the previous year's earnings was approved at the annual meeting of stockholders.

There is quoted hereafter a bylaw adopted at the annual meeting in 1938:

"ARTICLE VIII (Certificates of Patrons' Equity Reserve)

"Certificates of Patrons' Equity of the Association reserve may be issued to patrons to evidence the patrons' interest in such earnings of the association, which have been distributed on the basis of patronage and have been annually determined by the Board of Directors or members to be withheld in the assets of the association until such time as the Board of Directors in their discretion may decide to redeem.

"Such certificates of Patrons' Equity Reserve may contain the following provisions:

A. They must be redeemed in order of priority both as to date and number.

B. Must be subject to Articles of Incorporation and Bylaws.

C. Interest may be paid at the discretion of the Board of Directors but Rate of Interest may not exceed 4 percent.

D. Notice of intention to redeem any certificate must be mailed to each holder, and interest, if any paid, will cease to accrue from date of notice.

E. The Association may deposit in trust in any reliable bank or trust company any or all funds provided for redemption of such certificates to be delivered thereto for redemption.

F. In case of liquidation, winding-up or dissolution, such certificates shall be paid only after all corporate liabilities (including the liabilities arising from the issuance of Preferred Stock by this association, by [but] excluding its liability arising from the issuance of Common Stock) have been paid in full."

This bylaw is quoted for the reason that some reference is made to it in the opinion.

There is given hereafter the opinion of the Board of Tax Appeals, insofar as it relates to the right to deduct amounts credited to the members and held in the patrons' equity reserve:

"The Commissioner determined that the amounts credited by petitioner to its members and held in its 'Patrons' Equity Equity Reserve' account are not deductible from its gross income for the taxable years. Whether this determination is or is not correct is the first issue to be determined.

"Both parties recognize that there is no specific statutory provision for the deduction of patronage dividends from the gross income of a cooperative association. The Treasury Department, however, as pointed out in Fruit Growers Supply Co., 21 B.T.A. 315, 326; affd., 56 Fed.(2d) 90, with 'great liberality', has allowed such deductions 'to the end that substantial justice may be done to an association which is engaged in cooperative marketing or purchasing work but which may not be exempt from taxation.' The justification for the ruling rests upon the fact that the so-called dividends are in reality rebates upon the business transacted by the association with its members rather than true income to the association.

"Respondent, in determining the deficiency, correctly allowed the deduction of the amounts paid in cash by petitioner to its members, based upon the business transacted by them in each year, though payment was not made of such amounts until the following year. He concedes that a definite liability to make such payments -- clearly a prerequisite to their deduction -- arose during the taxable years. Home Builders Shipping Association, 8 B.T.A. 903; Anamosa Farmers Creamery Co., 13 B.T.A. 907; Farmers Union Cooperative Association, 13 B.T.A. 969; Farmers Union State Exchange, 30 B.T.A. 1051, 1066

"As to the amounts credited by petitioner to its members upon its books and not paid over to them during the following year respondent takes a different position. Pointing to some of the corporate records received in evidence, especially the minutes of the directors' meetings and the minutes of the annual meetings, he argues that they show petitioner was in need of working capital and that the members recognized the necessity of either borrowing it or raising it among themselves; that this could be, and was, accomplished by the members leaving a substantial portion of their dividends with petitioner; that the so-called reserve was not a true reserve, but an allocation of a part of petitioner's undivided surplus made in the hope of avoiding income tax; that setting aside a portion of its income in such an account 'was contrary to, or at least not provided for by, the state law, petitioner' Articles of Incorporation and its bylaws'; and that additional corporate action is required to be taken before petitioner becomes under any liability to pay to its members the amounts set aside.

"The evidence does indicate that petitioner was in need of working capital and that the membership desired to aid it in getting out of debt by leaving a portion of their dividends with it. It is also true that at least petitioner's directors knew all earnings placed in 'permanent surplus' would be included in its gross income in computing the amount of its income tax. The motive of petitioner and its members does not seem to be very material to the present controversy. It is important to determine, however, whether the action taken was in violation of State law or charter provisions and whether additional corporate action is required before petitioner is under any definite liability to make payment; so these questions will now be considered.

"Petitioner's articles of incorporation and bylaws follow quite closely the provisions of the Minnesota State law. Both provide for the reduction of operating costs, the setting aside of a reserve for depreciation, and the creation of a reserve against other possible losses. Both require that there be deducted an amount sufficient to pay interest on the paid-up capital of the association. The bylaws provide for the payment of interest at not to exceed 5 percent per annum. The State law authorizes the payment of interest at a rate not in excess of 6 percent per annum. There may also be deducted and set aside such amounts as may be required to provide for the erection of new or additional buildings or for additional machinery or equipment. Provision is also made for 'creating a reserve for permanent surplus.' The balance of the net income, in the language of the State statute, is to 'be considered and termed as "undivided surplus"

for such fiscal year and shall be available for distribution among the members of such cooperative association on the basis of patronage.' Distribution of the undivided surplus is required to be made annually on the basis of patronage during the preceding fiscal year.

"It is true that neither the State law nor petitioner's articles of incorporation and bylaws, at least prior to the annual meeting of 1938, specifically referred to a patrons' reserve account. The 'undivided surplus,' however, clearly belonged to the members or patrons and, both under the law of the State and under petitioner's bylaws, was required to be distributed to them annually on the basis of patronage. While the setting aside of a portion of such amount is not specifically authorized, there is nothing in the State statute or the bylaws prohibiting such action being taken. We are therefore of the opinion that when petitioner, with the consent and knowledge of its members, set aside a portion of its earnings in a reserve account and allocated it among them, it did not violate any provision of the State law or act in violation of its charter provisions.

"The next question is whether additional corporate action is required to be taken before petitioner becomes under a definite liability to pay to its members the amounts set aside to their credit. Petitioner points out that the amounts to be paid forthwith to its members in cash and the amounts to be held in reserve were both authorized at the same time and by the adoption of one resolution; that both were allocated to the members at the same time and entered upon the corporate ledger as credits; and that both were computed upon the business transacted with the association. It argues, therefore, that both were properly accrued as liabilities upon its books. We agree with petitioner. In our opinion all necessary steps were taken in the taxable years to obligate petitioner to pay the earnings over to its members. The resolutions of the board of directors recognized that the entire amounts - $53,601 in 1936 and $58,673.43 in 1937 - belonged to the members. The statutes and the bylaws so provide. If any other disposition of such earnings had been made - other than putting them in permanent surplus - the directors would have committed an unlawful act, which under the statutes of Minnesota would have been 'cause for the cancelation of the charter.' The amounts in question were not put in permanent surplus. They were allocated to the members, though held in reserve. Moreover, though perhaps wholly unnecessarily, the directors sought and secured the approval of the membership at the annual meetings of their action in withholding the portion of the earnings which had been set aside for them, and, in connection with the earnings for 1937, such approval was also secured during the month of December

and before the end of the taxable year of the action then contemplated - i.e., that 50 percent be paid in cash at once and 50 percent be placed to the credit of the members and be held in reserve.

"Respondent places considerable reliance upon the new bylaw adopted at the annual meeting in 1938 which, he says, indicates that petitioner was under no definite liability to pay the amounts credited upon its books to its members unless it should choose to do so. He relies particularly upon the last sentence of the bylaw, which provides that 'in case of liquidation, winding up or dissolution, such certificates shall be paid only after all corporate liabilities (including the liabilities arising from the issuance of preferred stock but excluding its liability arising from the issuance of common stock) have been paid in full.' This, he says, indicates that unless some definite corporate action is taken prior to the liquidation or dissolution of petitioner, the members will receive the credits which have been made to their respective accounts only in the event all corporate liabilities shall have been paid and all preferred stock redeemed.

"Petitioner, in its reply brief, argues that the new bylaw is immaterial to the present issue and that no corporate action taken during a succeeding year can add to, or detract from, the rights and obligations of the petitioner and its members which had come into being by virtue of corporate action previously taken. There is considerable substance to petitioner's argument. We are of the opinion, however, that if the bylaw is to be considered, still it does not have the effect that respondent contends it has. It recognizes that the amounts set aside and credited to the members belong to them, that interest must henceforth be paid, and, in the event of liquidation or dissolution of the cooperative, that the members shall have the rights of general creditors. No additional action is required to be taken by the corporation to create such liability.

"It is apparent we are of the opinion respondent erred in holding that the amounts credited to the members must be included in petitioner's income. One additional reason for so holding may be given. Petitioner's books were kept upon an accrual, as distinguished from a cash, basis. All events occurred within the taxable years determining the liability of petitioner to its members and the amounts thereof. United States v. Anderson, 269 U. S. 422. The fact that the entries could not be made upon petitioner's books until its audit of the year's business was completed is unimportant and does not deprive it of its right to accrue all proper items in closing its books for the year. It accrued upon its books, and

showed as accounts payable upon its balance sheet, the amounts credited to its members. This action was in accordance with the corporate resolutions adopted by it in December of each year. The amounts so credited, in our opinion, could have been withdrawn by the members at any time. In at least two instances, they were, in effect, withdrawn. As shown in our findings, they were applied by petitioner in liquidation of the members' accounts.

"Respondent cites an unpublished memorandum opinion of this Board holding that amounts set aside in an account entitled 'Reserve for Working Capital' by a cooperative association organized under the laws of Idaho are not deductible as patronage dividends. The cited decision has now been affirmed by the Circuit Court of Appeals for the Ninth Circuit. Cooperative Oil Association, Inc. v. Commissioner, 115 Fed. (2d) 666. An examination of the opinion of the court discloses that the taxpayer, as provided in its bylaws, had set aside a substantial portion of its earnings 'to create a reserve or reserve funds necessary to provide working capital.' In the letter to its members it stated that 'as rapidly as our reserves accumulate these earnings will be released and disbursed to you as patronage dividends.' The reserve established by the taxpayer in the cited case was similar to the 'permanent surplus' set aside by petitioner in the instant proceeding rather than to the amounts set aside by it in the patrons' equity reserve account and credited to its members. Additional corporate action was required before it was available to them. This fact distinguishes the cited case from the present.

"We are of the opinion and hold that respondent erred in including the amounts in issue in petitioner's income." (Underscoring added.)

Midland Cooperative Wholesale v. Commissioner of Internal Revenue, 44 B.T.A.

ARE GROWERS ENTITLED TO CANCEL THEIR MARKETING CONTRACTS WITH AN ASSOCIATION ON THE GROUND THAT IT HAS BREACHED ITS MARKETING AGREEMENT WITH THEM BY PERMITTING THE WITHDRAWAL OF OTHER GROWERS?

A number of growers brought an action in equity to cancel and rescind their marketing contracts with an association. In the lower court, a judgment was rendered for the association, and the case was appealed to the Supreme Court of the State of Washington.

It was contended on the part of the growers that they should be permitted to withdraw for the following reasons:

(1) That the association had adopted a bylaw under which members might withdraw upon the giving of 10 days' notice, and paying to the association money that might be due it;

(2) that the membership and marketing contracts had been procured through fraud; and

(3) that the association had breached its marketing contracts with the members by permitting eleven members to cancel and rescind their contracts with the association.

With respect to the first point, it was established, to the satisfaction of the court, that the bylaw authorizing the withdrawal, on 10 days' notice, had never been approved by a sufficient number of the members to make it effective.

With respect to the second point, one of the growers contended that he had been induced to sign the marketing contract because of the false representations that the association would not be formed unless 75 percent of the growers of the particular product in question would become members of the cooperative association. For purposes of the decision, the court assumed that this contention of the grower was correct, but nevertheless held that he was estopped by his conduct from making this contention.

In this connection, the court said, in part:

> "It is apparent that appellant Beaulaurier, with full knowledge of the facts which he considers fraudulent, deliberately aligned himself with other members and, acting as a member and the holder of a contract, took advantage of his membership and sought to amend the company's bylaws so that he could withdraw. He sought withdrawal, not upon the ground of fraud and overreaching, but upon the ground that he and others had a right to first amend the bylaws and then rescind their contracts in accordance with the terms of the proposed new law which he had

sought to bring into being. Clearly, by such acts he waived any false representations which had been made and cannot now complain. Kansas Wheat Growers Ass'n v. Oden, 124 Kan. 179, 257 P. 975."

* * *

"Waiver by conduct has been recognized by this court many times, the following being typical instances of the application of that principle: Buck v. Equitable Life Assur. Society, 96 Wash. 683, 165 P. 878; Yours Truly Biscuit Co. v. Lilly Co., 142 Wash. 513, 253 P. 817; Reynolds v. Travelers' Ins. Co., 176 Wash. 36, 28 P. 2d 310.

"We are in accord with the holding of the trial court that the appellant, by his actions in taking part in the meetings of the corporation, waived his right to raise the question of fraud."

The contention that the release by the association of the eleven members constituted a breach of its marketing contract with its other members, which entitled them to cancel and rescind their contracts, was disposed of by the court as follows:

"All of the appellants contend that respondent breached its contract with them when it allowed eleven members to withdraw from membership and to rescind their marketing contracts. The releases in question were made without the consent of the membership of the corporation, and a question was raised as to their validity in the case of Washington State Hop Producers, Inc. v. Eglin, Wash., 108 P. 2d 329. In that case we held that the release was binding on the association, even though it was not done with the consent of all of its members. We pointed out the facts that the releases were made because of threatened suits in most of the cases, and that compromises were effected with the released members whereby the association received a considerable amount of money. It was shown that the association had benefited by the compromise settlements, and that it had been to the advantage of the association to release these persons. Appellants in the case at bar, however, insist that even though the releases were valid and binding on the association they constituted a breach of the contracts between the association and appellants. They cite the case of Staple Cotton Co-op Ass'n v. Borodofsky, 143 Miss. 558, 108 So. 802, 806, in support of their contention. That case held that when the directors released certain members of a co-operative marketing association from their obligation to deliver their crops to the association, another member was

also released thereby, and an equitable bill brought by the association against the non-consenting member must fail. However, we do not regard that case as authority in favor of appellants in the case at bar.

"The language of the court in that case included the following sentence, after a declaration of the rule just mentioned: 'Any other view would be unreasonable, there being no compensation or benefit to the association.' (Italics supplied.)

"The qualification set forth clearly is applicable to the instant case, since, as we have already indicated, the association did receive compensation and benefit as a result of the releases, as distinguished from the factual situation in the Borodofsky case, supra.

"We do not regard the qualification suggested by the Mississippi court as a complete treatment of the problem here presented. Though there may have been compensation and benefit to the association, so as to make the release binding as to it, there is present the argument that the releases might well constitute a breach of the contract between the association and the non-consenting members. it if can be shown that the release altered the contract into which they entered, and that they suffered as a result of the alteration. Although our search of the authorities failed to reveal any other case in which this problem has arisen with reference to associations of this type, we have encountered some cases in which subscribers to corporate stock have been released without the consent of some of the other subscribers. Rutz v. Esler & Ropiequet Mfg. Co., 3 Ill. App. 83; McCully v. Pittsburgh & C. R. Co., 32 Pa. 25. In those cases the holdings were to the effect that the subscription agreements were not only with the company, but with the other subscribers, and they afforded mutual considerations for each other. It was held that to release some of them and hold the others would be to enforce contracts they never made. Up to that point, the principles enunciated would seem to mitigate against respondent's position, since the situation here presented is closely analogous to the stock subscription cases. However, we note that in those cases there is added the qualification that no person should be able to rescind or be released from his subscription because of the release of others if he assented to these releases, expressly or impliedly. We hold that appellants in the case at bar did impliedly consent to the releases in question, and that they are therefore precluded from basing their right to rescind their contracts upon those releases. The evidence in the case was to the effect that appellants knew of the releases for a considerable period of time after they took place, and also showed that all of

appellants participated as members in the association's affairs thereafter. By so acting, appellants impliedly approved the actions of the directors in granting the releases. We therefore find no merit in appellants' third cause of action." (Underscoring added.)

The appellant growers also contended that the trial court had erred in issuing a mandatory injunction which compelled the growers to deliver their products to the association, but the Supreme Court sustained the action of the lower court in thie regard. The appellants also contended that the trial court had erred in allowing an attorney's fee of $500. The Supreme Court, however, pointed out that the payment of a reasonable attorney's fee was authorized in the bylaws. The court not only sustained the trial court in allowing the attorney's fee, but on a cross appeal of the association, increased the attorney's fee to $1,000.

The case was reversed and remanded, with instructions to enter judgment in conformity with the opinion.

Beaulaurier v. Washington State Hop Producers, Inc., _____ Wash. _____, 111 P. 2d 559.

In connection with the third contention of the growers, see also: California Bean Growers Association v. Rindge Land and Navigation Co., 199 Cal. 168, 248 P. 658, 47 A.L.R. 904; and Phez Co. v. Salem Fruit Union, 103 Ore. 514, 201 P. 222, 205 P. 970, 25 A.L.R. 1090.